INFORMED BUDGETEER

FARMERS' CASH CROP NOT GOVERNMENT'S CASH COW

- In all the furor the past few weeks over the McCain tobacco bill and the withdrawal of RJ Reynolds from the negotiations, even the most attentive budgeteer could have missed the recent release of a CBO paper (available at www.cbo.gov) analyzing the original proposed settlement between tobacco companies and states' attorneys general reached last June.

- While an estimate of the federal budgetary impact of the McCain bill is still not expected for several weeks (elements of the bill have not yet been finalized), CBO's analysis of the original settlement is instructive for keeping in perspective the bill's ballyhooed features (it supposedly would collect and then spend $500 billion from tobacco companies).

- The key number bandied about as the amount extracted from tobacco companies in the original settlement was $369 billion over 25 years. CBO's paper, however, makes the point that there is little likelihood, **by design**, that the tobacco companies would ever pay out that much.

- The main reason is that the schedule of payments in the settlement, advertised to total to $369 billion, is based on current levels of cigarette consumption. Because one of the key features of the settlement is to reduce consumption of cigarettes, the negotiated payments are expected to result in higher cigarette prices that will discourage smoking and result in decreased consumption.

- Because the settlement provides that decreased consumption will allow tobacco companies to reduce their scheduled payments, CBO lays out two scenarios for how much the payments could fall. One scenario assumes that the companies would pass along the cost of their settlement to their customers exactly, increasing cigarette prices by 63 cents from the current price of about $2 per pack. Given such a price increase, CBO estimates that the resulting drop in consumption would decrease companies' payment to around $293 billion, instead of $369 billion.

- The other scenario is that tobacco companies would increase cigarette prices to more than recover the amount of payments under the settlement, perhaps by as much as $1.50 per pack. The resulting decrease in consumption would produce a larger drop in total settlement payments--which could range around $240 billion.

SCENARIOS FOR TOBACCO COMPANY PAYMENTS UNDER ORIGINAL SETTLEMENT
($ in Billions)

Price Increase[A] ($ per pack)	Total Industry Payments[A]	Amount Recorded on Government Budgets[B]
None	369	277
0.63	293	220
1.50	240	180

[A]SOURCE: CBO; [B]reflects excise tax offset.

- As the CBO paper only examined the tobacco settlement from the perspective of its effect on tobacco companies (their payments, price changes, and changes in demand for their product), the impact of the payments on the federal and states' budget ledgers was left until another time. Now that the Senate Commerce Committee has approved its version of the settlement, it is important to keep in mind other estimating considerations that will affect the amount collected by the federal government in any enacted settlement.

- Because it is likely that any tobacco company payments resulting from legislation will be classified as an excise tax, estimators will count only 75% of the total expected payments as federal receipts, after making a 25% adjustment for an "excise tax offset". This estimating convention is derived from the following (oversimplified) argument: given a fixed nominal GDP, increasing indirect business taxes (such as by increasing cigarette prices) results in a decrease in incomes, which results in a decrease (25%) in income and payroll tax receipts. Therefore, the net budgetary effect of an increase in an excise tax is 75% of the gross amount of the tax.

- This means that under the two scenarios of price increase/demand reduction that CBO considered, the actual amount recorded on the federal government's books under the original settlement would be in the $180 billion to $220 billion range--again, far less than the $369 billion usually associated with that settlement.

- For the McCain bill, which appears to promise a take of $500 billion over 25 years, the amounts estimators are likely to attribute to the bill could fall similarly short, meaning that there is not as much to spend as some would have you believe.

SENATOR MOYNIHAN'S SOCIAL SECURITY PROPOSAL

- Senator Moynihan has proposed a comprehensive bill to reform Social Security (S. 1792).

SENATOR MOYNIHAN'S SOCIAL SECURITY PROPOSAL
Preliminary CBO Estimates ($ Billions)

TOTAL BUDGETARY EFFECTS	1999-2003	1999-2008
Tax Provisions		
Reduce Payroll Tax	-294.6	-779.8
Increase Wage Base	23.9	98.4
Cover State & Local Workers	5.4	40.9
Increase Taxation of Benefits	140.3	305.1
CPI Minus 1% (Taxes)	54.4	240.8
Other/Interactions	10.4	6.3
Subtotal, Taxes	-60.2	-88.3
Spending Provisions		
CPI Minus 1% (Social Security)	-54.4	-223.5
CPI Minus 1% (Non-Social Security)	-13.4	-55.4
Increase Computation Years 35 to 38	-0.5	-10.7
Raise the Retirement Age	0	-0.9
Eliminate the Earnings Test	8.5	64.5
Other/Interactions	4.2	14
Subtotal, Spending	-55.6	-212
Unified budget surplus(+)/deficit(-)	-4.6	123.7

- Payroll Tax and Voluntary Contribution Schedule: Senator Moynihan proposes to change the regular payroll tax rate schedule to more closely follow a "pay-as-you-go" approach.

- Beginning in 2001, the employer and employee would each get a 1 percentage point reduction in their payroll tax rate, from 6.2 to 5.2%, for a combined rate of 10.4%. However, if the employee elects to put his 1% in a voluntary savings account, the employer is required to match it with a 1% contribution.

- In this circumstance, the employee and employer are still paying a combined 12.4%, and even more in later years. If the employee keeps his payroll tax cut, the employer can keep the other 1% too.

- Other Tax Increases: Senator Moynihan's plan includes some substantial revenue increasing provisions. Increase the wage base subject to the payroll tax from $68,400 in 1998 to $97,500 in 2003 (the base would be $82,800 in 2003 under current law). Increase the taxation of Social Security benefits by eliminating the income thresholds used currently to determine tax liability (now at $25,000 for individuals and $32,000 for couples). Cover all new State and local workers under Social Security.
- Benefit Changes: The plan includes the following benefit changes: CPI minus 1 percentage point for COLAs beginning in 1999. Increase the retirement age to 68 in 2017 and 70 in 2065. Repeal the earnings test. Increase the number of years of work in the

computation formula from 35 to 38. Beginning in 2001, the employer and employee would each get a 1 percentage point reduction in their payroll tax rate, from 6.2 to 5.2%, for a combined rate of 10.4 %.

EMERGENCY SUPPLEMENTAL CONFERENCE

- The conference on the FY 1998 Emergency Supplemental Appropriations Act for Recovery from Natural Disasters, and for Overseas Peacekeeping Efforts faces an uphill battle as it addresses two significantly different bills.

- The Senate-passed bill (see table) includes $2.4 billion in emergency spending for U.S. military operations in Bosnia and Southwestern Asia (Iraq); $3 billion in emergency aid for victims of natural disasters; $18 billion in non-emergency budget authority for the International Monetary Fund (IMF); and a little over $100 million for non-emergency supplementals. The total bill provides $23.4 billion in BA and an estimated $1.1 billion in outlays for FY 1998 according to CBO estimates. Outlays in FY 1999 would be an estimated $1.9 billion.

Summary: CBO Estimate Senate Passed 1998 Supplemental
(By Fiscal Year, $ in millions)

	1998	1999	2000	2001	2002	Total[A]
Non-Emergencies						
Defense						
BA	-4	0	0	0	0	-4
OT	6	-7	-2	-1	0	-4
Non-Defense						
BA	17953	0	0	0	0	17953
OT	95	120	43	17	5	280
TOTAL						
BA	17949	0	0	0	0	17949
OT	101	113	41	16	5	276
Emergencies						
Defense						
BA	2415	0	0	0	0	2415
OT	496	1401	393	83	21	2401
Non-Defense						
BA	2987	0	0	0	0	2987
OT	510	424	772	827	409	2955
TOTAL						
BA	5402	0	0	0	0	5402
OT	1006	1825	1165	910	430	5356
Non-Emer & Emer						
Defense						
BA	2411	0	0	0	0	2411
OT	502	1394	391	82	21	2397
Non-Defense						
BA	20940	0	0	0	0	20940
OT	605	544	815	844	414	3235
TOTAL						
BA	23351	0	0	0	0	23351
OT	1107	1938	1206	926	435	5632

[A]Totals include 2003.

- The House-passed bill (see table) includes $2.3 billion in emergency spending for U.S. military operations; $0.6 billion in emergency disaster aid; and offsetting savings of $2.9 billion in BA. The House bill totals a net -$2 million in BA and would result in net outlays of $0.6 billion in FY 1998 and $1.2 billion in FY 1999. The House has included IMF in a separate bill (H.R. 3580) along with non-emergency supplemental funding, an appropriation to address U.S. arrearage payments to the United Nations, and veterans compensation COLA funding.

Summary: CBO Estimate House Passed 1998 Supplemental
(By Fiscal Year, $ in millions)

	1998	1999	2000	2001	2002	Total
Non-Emergencies						
Defense						
BA	0	0	0	0	0	0
OT	1	-1	0	0	0	0
Non-Defense						
BA	-2885	0	0	0	0	-2885
OT	-26	-553	-1936	-31	-3	-2550
TOTAL						
BA	-2885	0	0	0	0	-2885
OT	-25	-554	-1936	-31	-3	-2550
Emergencies						
Defense						
BA	2288	0	0	0	0	2288
OT	487	1467	285	35	7	2281
Non-Defense						
BA	595	0	0	0	0	595
OT	153	286	100	37	18	594
TOTAL						
BA	2883	0	0	0	0	2883
OT	640	1753	385	72	25	2875
Non-Emer &Emerg						
Defense						
BA	2288	0	0	0	0	2288
OT	488	1466	285	35	7	2281
Non-Defense						
BA	-2290	0	0	0	0	-2290
OT	127	-267	-1836	6	15	-1956
TOTAL						
BA	-2	0	0	0	0	-2
OT	615	1199	-1551	41	22	325

- The conference must address the issue of whether to offset the emergency spending for both defense and disaster aid. While the House has rescinded some $2.9 billion, over three-quarters of the offsetting savings come from Section 8 housing funding, which will need to be replenished in 1999 to renew expiring contracts. There are no outlay savings associated with this $2.2 billion rescission of Section 8 funding in FY 1998, but outlays score in the outyears.

- A second issue is the House approach of offsetting defense spending with non-defense reductions, a move that would make a conference report subject to a 60-vote point of order in the Senate for violating the “firewalls” between defense and nondefense spending. The Senate bill declares this spending an “emergency requirement” and outside the caps, so there is no firewalls violation.

- Finally, the disposition of the IMF funding remains the key issue to any conference on the FY 1998 Emergency Supplemental Appropriations bill. The Senate fully funds the $3.4 billion for the New Arrangements to Borrow (NAB), and $14.5 billion for the quota increase, and places conditions upon the use of this $17.9 billion. The House bill in conference has no IMF funding.

CALENDAR

April 28: Japan's Economic Difficulties and Their Potential US Impact: Senate Budget Committee hearing; Witnesses include: Tadashi Nakamae, President, Nakamae International Economic Research, John Makin, Resident Scholar, American Enterprise Institute, David Malpass, Director for International Economics, Bear Stearns. Dirksen 608, 10:00am.

April 28: Supplemental Conference.